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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF H2O, INC. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICES.	DOCKET NO. W-02234A-07-0557 **STAFF'S REPLY BRIEF**

I. INTRODUCTION

Staff has reviewed the closing brief provided by H2O, Inc, ("H2O" or "Company") filed on June 15, 2009. Although Staff had intended its initial brief to be comprehensive of its position, and Staff continues to rely on arguments made in its opening brief, Staff feels it is necessary to respond to various issues raised in the Company's initial post-hearing brief.

II. STAFF'S RECOMMENDATION DOES NOT PRODUCE A MISMATCH

In its initial post-hearing brief, H2O describes Staff's rate base recommendation as creating a matching problem. H2O Op. Br. at 3. The Company's rationale is that applying the negative adjustment from inclusion of all contributed and advanced capital even when there is not corresponding plant in service creates a mismatch regarding the negative adjustment. *Id.* The Company goes on to describe the Staff recommendation as a penalty against the Company for "not building infrastructure that the Company prudently determined would be excess capacity due to the slow down in housing development." *Id.* at 4.

The Company's position on the rate base treatment of contributed and advanced capital is not consistent with Commission practice for numerous reasons. As Staff explained, the fact that there is no existing plant in service tied to the customer supplied capital is not a sufficient reason to exclude it because, "the Company has use of these funds regardless of whether it has expended the funds for plant." Exhibit S-2 at 8. Staff's application of all customer supplied capital as a reduction to rate base is consistent with Commission treatment of these funds as was explained in the testimony of Mr. Brendan Aladi.

> Typically, funds received as CIAC or AIAC are used to build plant which may ultimately be in rate base. Plant that is used and useful for the provision of utility service is a component of rate base. CIAC and AIAC are also components of rate base. As components of rate base, plant differs from CIAC and AIAC in that plant increases rate base and CIAC and AIAC decrease rate base. Plant that is under construction ("CWIP") is normally not a component of the rate base calculation. Thus funds received as CIAC or AIAC that are funding CWIP are included in the rate base calculation while the CWIP is not included in the rate base calculation. As a result, the plant included in the rate base calculation may not equal CIAC and AIAC funds received.

Exhibit S-3 at 4:22-5:4.

Staff would further point out that Staff's recommendation is consistent with the Arizona Administrative Code (A.A.C.) Rule R14-2-103 and in particular Appendix B, Schedule B-1 that was admitted as Exhibit S-5. As the schedule sets out, non-investor supplied funds are applied as reductions to rate base. Tr. at 142-143. However, the Company argues that the rule is only a rule and not an expression of a policy by the Commission. H2O Op. Br. at 6-9.

Setting aside that adoption of rules is an expression of Commission policy, the Commission has recently addressed the application of this rule and it has expressly stated that Staff's position is correct. In the case of UNS Gas Inc.'s application for a rate increase in Docket No. G-04204A-06-0463, UNS Gas argued that customer supplied advances should not be reflected as a deduction to rate base just as H2O has in this case. *See* Decision No. 70011 (November 27, 2007) at 8-9. In that vein, UNS Gas also argued that deducting rate base to reflect advanced funds would disincent utilities from seeking customer supplied capital as an offset to infrastructure capital costs. *Id.* at 9; *see also* Decision No. 70360 (May 27, 2008) at 10-11 where similar arguments were raised by UNS Electric. Thus, UNS Gas argued much as the Company has in this application in defense of continuing its Capacity Reservation Charge ("CRC") that there will be difficulty meeting infrastructure requirements under the Staff application of the rule. *See* Docket No. W-02234A-07-0557 Tr. at 56:15-18.

The Commission, however, determined that Staff's application of R14-2-103 correctly reflected the treatment of non-investor supplied capital. "We agree with Staff and RUCO that advances represent customer-supplied funds that are properly deducted from the Company's rate base. Indeed, the Commission's own rules contemplate that such a deduction is required..." Decision No. 70011 at 9:16-18; *see also* Decision No. 70360 at 10:22-25. Staff's recommendation is thus consistent with the present application of the rule.

In response, the Company would argue that it is also possible under the rules to adjust rate base under a separate schedule. H2O Op. Br. at 7. Further, the Company argues that Staff's position would produce inequities considering that the recommendation would result in a negative rate base and have cash flow impacts. *Id.* Neither contention undermines Staff's recommendation, however.

To the extent that it is possible to pro forma adjust the rate base per A.A.C. R14-2-103(A)(3)(i) to obtain a "normal or more realistic relationship between revenues, expenses and rate base," the Company has not explained how inclusion of all customer supplied capital is inconsistent with the normal or realistic conditions the Company operates under. For example, Company witness Tom Bourassa opined that the large quantities of unexpended contributions and advances were the result of the Company's existing up front payment policy. "And so really what we're dealing with in this case is a timing problem. Well, it's a timing issue created by the company's collection policy, which is collect these things up front. That's why we have a huge amount of unexpended CIAC." Tr. at 55:9-13; *see also* Tr. at 55:21-56:2. Clearly, the substantial amount of unexpended customer supplied funds on hand with no associated plant in service is an ordinary incident to the Company's collection policy and therefore is representative of the normal rate base relationships that H2O experiences. Said differently, the issue that the Company has described represents a normal component of regulatory lag.

Likewise, Staff disagrees that inequities result from adopting Staff's proposed rate base treatment for the contributions and advances. As Staff explained in the initial post hearing brief, the cash flow issues that the Company has identified are fallouts of the differing operating expense recommendations taken by the parties. In turn, the operating expense differences were driven by the different positions on rate base. For example, there was a $195,853 difference between the Company's and Staff's operating expense recommendations based on depreciation expense alone. Exhibit A-3 at 4. The differences in operating expenses give rise to the difference in operating incomes between the parties' positions. However, the overall revenue requirements for both parties remains relatively similar at approximately $25,784 difference between the two positions because depreciation is a non-cash expense. By comparison, the Company identifies a sum nearly three times the difference in recommended revenue requirements as the difference in cash flows. *Id.*

Staff maintains that the income statement differences identified by H2O reflect incidental accounting treatments that result from the different rate base recommendations. As the similar revenue requirement proposals of both parties demonstrate, there is minimal actual difference in revenues and cash flow to the Company. As such, there is little merit to the contention that Staff's recommendation produces inequities for the Company. Therefore, Staff believes that the Company has not provided a sufficient basis for deviating from the traditional application of the rule to these circumstances.

III. STAFF'S RATE BASE RECOMMENDATION IS NOT PUNITIVE

H2O describes Staff's rate base recommendation as a penalty for not building infrastructure that would result in excess capacity. H2O Op. Br. at 4, 9. The accusation is baseless. As explained above, Staff's recommendation is entirely premised on how the rules would adjust rate base under the circumstances presented. To the extent that the impact of Staff's recommendation would be to render rate base negative, Staff has also recommended an operating margin approach so as to provide the Company with a positive cash flow and rates that are just and reasonable. Likewise, Staff's recommended operating margin is based on a revenue requirement that is about $25,784 of the Company's recommendation. As the Company noted, Staff's operating margin produces a result that is similar to the result the Company reached using a positive rate base and a cost of capital approach to determine a rate of return. Tr. at 12:20-22. Clearly Staff's proposed rate base treatment is not punitive in design or effect.

Confusingly, although H2O describes Staff's recommendation as penalizing the Company for prudently not building excess capacity, in the next breath, the Company suggests that the recommendation also penalizes it for not including the unexpended funds in rate base. H2O Op. Br. at 4. The argument is not compelling, for the least reason being that it suggests Staff's position contains some penalty that is premised on the Company not proposing the same treatment of CIAC and AIAC at the outset. There is no additional consequence to the Company from implementing Staff's proposal that would be different than if the Company were to include all CIAC and AIAC. Consequently, there is no component of an added penalty attached to the recommendation.

IV. ELIMINATING THE COMPANY'S CAPACITY RESERVATION CHARGE IS REASONABLE UNDER THE CIRCUMSTANCES

Much as UNS Gas and UNS Electric argued in the applications leading up to Decision Nos. 70011 and 70360, H2O argues that Staff's recommendation will undermine the ability of utilities to finance infrastructure capital costs. In this case, however, the Company points to Staff's recommendation to discontinue the CRC as the basis for the allegation. H2O Op. Br. at 9-12. Consistent with this alarmist belief, the Company also has misattributed to Staff's recommendation an intention to refund unexpended contributions. *Id.* at 11:9-23.

Certainly, the Commission may reach the conclusion that it is appropriate to refund unspent contributions in the event that the CRC is eliminated. Tr. at 98. Likewise, it may be a natural consequence of terminating the CRC per the tariff. *See* Exhibit A-6 at paragraph IV-I. Staff has not reached any conclusions about the appropriateness of any refunds or whether there are projects to be built that account for the entirety of the unexpended contributions as the Company asserts. H2O Op. Br. at 11. Staff's concern remains focused on the fact that the Company presently has an overabundance of non-investor capital funding its growth. Likewise this is not a fact that is reasonably in dispute as the Company has acknowledged that its total capital structure is unbalanced. Tr. at 53-55.

The present circumstances give rise to concerns that in the future the Company will have substantial difficulty funding necessary capital improvements and replacements when it comes time to repair and replace infrastructure that was funded by non-investors. The Company does not dispute this conclusion. Tr. at 49-56. However, H2O expresses concern that it will not be able to adequately finance infrastructure requirements without the CRC. H2O Op. Br. at 12. As Staff stated in its initial brief, this is not a sound justification for continuing the hook up fee because the Company's exposure to these difficulties will only increase over time, all other things being equal.

The better approach, Staff believes, would be to discontinue the CRC and encourage more investment in the Company. As Staff testified, the Company may obtain other sources of capital to fund improvements besides contributions. Tr. at 112:8-13. Although the Company argues that it would be exceedingly difficult to attract new equity under these circumstances, Staff would suggest that it is both possible and necessary for the benefit of ratepayers and utility alike. For example, the Company may look attractive to investors because of its earning potential. Tr. at 139. The fact that it is presently over-earning is the very basis for the present matter. *Id.* Likewise, the Company could find a buyer with more capital available. *Id.* It is thus premature to reach the conclusion that H2O has that the terminating the CRC will impede the Company's ability to fund plant on a going forward basis.

IV. CONCLUSION

For all the above stated reasons and those stated in Staff's initial post-hearing brief, Staff believes that its recommendations are reasonable and should be adopted.

RESPECTFULLY submitted this 29th day of June, 2009.

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